Petition

81-991

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In The

Supreme Court of the United States

OCTOBER TERM, 1981

No. _____

RICHARD ENGELSTAD and RALPH ENGELSTAD,
Petitioners,

vs.

CAL SWENSON and CAROLYN SWENSON,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

1. Whether the purchasers of unregistered securities in interstate commerce are entitled to the remedy of rescission pursuant to Section 12(1) of the Securities Act of 1933 [15 U.S.C. 77l (1)] where the purchasers resold a substantial portion of the securities purchased prior to bringing suit against their sellers.

2. Whether the courts below erred in allowing the purchasers of unregistered securities in interstate commerce to recover the entire consideration paid for the securities (plus interest) where the purchasers had been reimbursed for a portion of the consideration paid by the corporation itself and where the purchasers benefited to the extent of the proceeds of the securities resold.

3. Whether the courts below should have applied the "out-of-pocket" measure of damages in this case rather than the remedy of rescission.

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RICHARD ENGELSTAD and RALPH ENGELSTAD,

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vs.

CAL SWENSON and CAROLYN SWENSON,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

RALPH ENGELSTAD and RICHARD ENGELSTAD, by their attorneys, respectfully pray that a Writ of Certiorari issue to review the decision of the United States Court of Appeals for the Fifth Circuit filed on October 16, 1981.

OPINIONS BELOW

The original District Court Judgment decreeing that CAL SWENSON and CAROLYN SWENSON take nothing from RALPH ENGELSTAD and RICHARD ENGELSTAD dated February 9, 1979 is printed at pages C-1, *infra*, and is not officially reported. The Judgment of the United States Court of Appeals for the Fifth Circuit dated September 24, 1980 is printed at pages D-1 to D-13, *infra*, and is officially reported at 626 F.2d 421 (5th Cir. 1980). The Judgment of the Court of Appeals referred to above reversed the Judgment of the United States District Court in part and remanded the case to the District Court for a determination of damages and entry of Judgment for CAL SWENSON and CAROLYN SWENSON.

The Judgment of the United States District Court for the Northern District of Texas, Amarillo Division, upon remand, is printed at pages B-1 to B-2, infra, and is not officially reported. The Judgment of the United District Court of Appeals for the Fifth Circuit upon appeal of the Second District Court Judgment is printed at pages A-1, *infra*, and is not officially reported.

JURISDICTION

The date of the Order and Judgment of the United States Court of Appeals for the Fifth Circuit sought to be reviewed is October 16, 1981 which is also the date of its filing. The jurisdiction of this court is invoked under 28 U.S.C., Section 1254 (1) and under Rule 17.1 of the United States Supreme Court Rules.

STATUTE INVOLVED

The Securities Act of 1933, as amended, Title 15, United States Code, Section 77l (1) states as follows:

> "Any person who —(1)— offers or sells a security in violation of Section 77e of this Title * * * shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

STATEMENT OF THE CASE

CAL SWENSON and CAROLYN SWENSON, Respondents herein, commenced this action against RALPH ENGELSTAD and RICHARD ENGELSTAD, Petitioners herein, in the United States District Court for the Northern District of Texas, Amarillo Division, seeking to recover damages allegedly sustained as a result of their purchase of the controlling interest in the stock of the corporation known as AMARILLO WRANGLERS, INC. Federal Court jurisdiction was asserted under 28 U.S.C. 1332 a (1)[Diversity of Citizenship] and under the Securities Act of 1933, 15 U.S.C. 77v (a) and the Securities Exchange Act of 1934, 15 U.S.C. 78aa.

AMARILLO WRANGLERS, INC. was a franchised member of the SOUTHWEST HOCKEY LEAGUE which was founded by RALPH ENGELSTAD in 1975. Initially, a controlling interest of AMARILLO WRANGLERS, INC. was owned by RICHARD ENGELSTAD. In early 1976, CAL SWENSON and CAROLYN SWENSON purchased all of the stock of

RICHARD ENGELSTAD and two minority stockholders in AMARILLO WRANGLERS, INC. The total consideration paid by the SWENSONS for the stock at issue was $116,000.00. The stock of AMARILLO WRANGLERS, INC. was never registered with the Securities Exchange Commission.

It is undisputed from the record that out of the total consideration of $116,000.00 pursuant to the agreement of the parties $26,000.00 represented money utilized for the payment of existing debts of AMARILLO WRANGLERS, INC. from the purchase price. After the SWENSONS purchased the stock in question, a note was given to them by the corporation to reimburse them for the sum of $26,000.00 which was used by RICHARD ENGELSTAD for payment of the debts of the corporation. Several payments were made on this note by the corporation to the SWENSONS prior to the failure of the corporation and the filing of this action.

It is also undisputed that after the purchase of the stock by the SWENSONS they sold a substantial amount of the stock to third parties for the sum of $40,750.00. The SWENSONS entered into agreements with their purchasers to share prorata with them any sum that the SWENSONS might recover against the ENGELSTADS in this action and all of the stock was tendered into the registry of the District Court.

Recovery by the SWENSONS was sought against the ENGELSTADS under Sections 12(1), 12(2) and 15 of the Securities Act of 1933 [15 U.S.C. 77l (1), 77l (2), 77o], Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. 78j (b)], Securities Exchange Rule 10b-5,

[17 C.F.R. 240.10b (5)] and under various state statutes. After a jury trial in the District Court in which a verdict was rendered favoring the ENGELSTADS, a take-nothing Judgment was rendered against the SWENSONS. Appeal was perfected from that Judgment to the Court of Appeals for the Fifth Circuit which rendered an opinion affirming the District Court's Judgment absolving the ENGELSTADS of all liability to the SWENSONS under the fraud counts of their complaint and under the state law claims; however, the Court of Appeals reversed the District Court's Judgment and remanded the case to that court for a determination of damages because of a finding that as a matter of law the ENGELSTADS were liable to the SWENSONS under Section 12(1) of the Securities Act of 1933 [15 U.S.C. 771 (1)].

Upon remand the DISTRICT COURT entered a Judgment for the SWENSONS for the total amount paid ($116,000.00) plus prejudgment interest at the rate of six percent (6%) per annum and postjudgment interest at the rate of nine percent (9%) per annum. The mandate of the United States Court of Appeals for the Fifth Circuit provided for postjudgment interest to accrue from the date of the original District Court Judgment.

An appeal was perfected from the second District Court's Judgment to the United States Court of Appeals for the Fifth Circuit. That court rendered a per curiam opinion on October 16, 1981 affirming the District Court's Judgment above referred to.

ARGUMENT

The decision of the United States Court of Appeals for the Fifth Circuit affirming the District Court's Judgment favoring the SWENSONS for a full return to them of the consideration paid for the securities at issue should be reviewed by this court to resolve an apparent conflict of decisions between the Circuit Courts concerning the proper relief to be afforded to purchasers of unregistered securities in interstate commerce. While both the Securities Act of 1933 and the Securities Exchange Act of 1934 have been the basis of many actions in recent years, the decisions of this court and the lower federal courts have been few dealing directly with the subject of the appropriate relief afforded to a purchaser of unregistered securities in interstate commerce. An opinion of this court clarifying the uncertainty which presently exists in this area is necessary in order to put this problem to rest.

The statute under which the ENGELSTADS were held liable describes generally the type of relief to which the SWENSONS are entitled. This statute, 15 U.S.C. 77l (1), in the pertinent part, states as follows:

> "Any person who —(1)— offers or sells a security in violation of Section 77e of this Title * * * shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of any such security, or for damages if he no longer owns the security."

Upon initial examination, this statute appears relatively simple; however, when it is attempted to be applied, it becomes vastly more complex. The facts are

undisputed as shown by the record which will aid the court in the resolution of the issues presented by this Petition.

Under the agreement of the parties, the SWENSONS paid a total amount of $116,000.00, of that sum they paid $90,000.00 for the stock at issue and $26,000.00 for current debts of the corporation (a requirement of the sellers because of personal liability exposure for these debts). After the SWENSONS' acquisition of the stock, they were then the majority stockholders of the corporation. Being in control, they put into effect a stock split of five (5) new shares for one (1) old share. They then sold a substantial amount of the new stock to third parties and received consideration for such sales of $40,750.00. It is unclear from the record what use the SWENSONS made of the proceeds of their stock sales; however, it is clear that they have never refunded any of that sum to any of their purchasers.

After the commencement of this action, the SWENSONS entered into agreements with their buyers whereby they attempted to get the stock back that they had sold for use in tendering the same to the ENGELSTADS in an attempt to qualify for their plea of rescission. In these agreements, the SWENSONS agreed to share prorata with their purchasers any recovery that they ultimately may receive in this case. They also obtained an agreement from their purchasers not to sue the SWENSONS because of their sale of the stock in question. By the time of trial, the SWENSONS had paid nothing to their purchasers to refund to them any of the money thay had received from their stock sales.

There are very few cases as yet decided which are helpful on the question of the proper relief which should be afforded to the SWENSONS in a case of this nature. The SWENSONS contend that they are entitled to the remedy of rescission because they have been successful in rescinding their sales to get the stock back for tender in these proceedings. It appears clear from the statute above described that the remedy of rescission is available only when the purchasers are capable of returning the stock to their sellers; otherwise, the relief to be afforded is damages. The United States Court of Appeals of the Fifth Circuit on the first appeal in this case after finding liability under Section 12(1) of the 1933 Securities Act remanded the case to the District Court "for a determination of damages." Rescission is a remedy which presumes that the parties can be restored to the status quo ante, *Baumel v. Rosen*, 412 F.2d 571 (4th Cir., 1969).

The lower courts in this case have permitted the SWENSONS to rescind their purchase of the stock at issue by holding the ENGELSTADS liable for the full consideration paid plus interest. This result is in direct conflict with the Second Circuit's opinion in the case *Mott v. Tri-Continental Financial Corporation*, 330 F.2d 468 (2nd Cir., 1964). In that case, a purchaser of stock sued for rescission for alleged misrepresentations by the sellers. The action was brought in part under Section 12(2) of the Securities Act of 1933 [15 U.S.C. 771(2)]. The facts of that case indicate that the plaintiff purchased 50,000 shares of common stock in the Commonwealth Oil Refinery Company, Inc. for $14.00 per share for a total consideration of $700,000.00. The plaintiff, immediately after his purchase, sold all of the shares of stock for

exactly the same amount per share that he had paid. These sales were made to members of his family and related entities. 5,000 shares were sold to his son; 5,000 shares were sold to his daughter and 40,000 shares were sold to a trust for another daughter. About two years after the purchase, the plaintiff sued the company from whom he had purchased the shares for rescission. Significantly, before commencement of the suit, the plaintiff had made arrangements with his purchasers for return of the stock. All of his purchasers had agreed to tender the stock they had bought to the defendant corporation; thus, the plaintiff attempted to put the defendant in the status quo ante to qualify for the remedy of rescission. The Court of Appeals for the Second Circuit affirmed a judgment for the defendant on the grounds that the plaintiff could show no injury and even though the shares were tendered back to the defendant by the purchasers from the plaintiff, the plaintiff was not entitled to rescission under Section 12(2) of the 1933 Securities Act.[1]

In the case *Sarlie v. E. L. Bruce Co.*, 265 F.Supp. 371, (USDC, New York, 1967), a defrauded buyer was entitled to recover the difference between the purchase price paid

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[1] In so holding the Court commented as follows:

"Mott chose to effect this transaction in the form of a purchase and subsequent resale. Having chosen to sell the shares immediately to others at no loss to himself, Mott cannot now deny that his interest in the transaction terminated upon the receipt of the $140,000.00 in cash and the $560,000.00 promissory note. That four years later he relieved the trust of its obligation on the note in no way affects the principle of law here in issue. There is a prerequisite to restitution that a party disgorge to the other party any proceeds the former has received upon the disposition of the original property. *Marr v. Tumulty*, 256, N.Y. 15, 175 N.E. 356 (1931). Thus, Mott would turn over to Tri-Continental the $700,000.00 proceeds from his sale to Harding Mott, Mrs. Sanderson and the trust, and Tri-Continental would return to Mott the $700,000.00 proceeds from the original sale — an exercise in futility."

for a security and the amount received on the resale thereof.

In this case, the SWENSONS sold a part of their stock for more money per share than they had paid for the stock. What they did with the money that represented the proceeds of these sales is irrelevant. Equally irrelevant are the agreements existing between the SWENSONS and their buyers to share prorata in any recovery that they may make in this case. To allow the SWENSONS to recover the entire amount in this case to share with their buyers while allowing the SWENSONS to keep the money received by them from their sales appears to be wholly unjust.

One Court of Appeals has recognized that some measures in a case of this kind would be required (constructive trust) to prevent the unfair result pointed out herein, *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2nd Cir., 1969).

If the SWENSONS are not entitled to the remedy of rescission because of their subsequent resale of the stock, the statute states that they are entitled to "damages." This statute does not specify or describe how such damages shall be measured. Similarly, the securities statutes governing fraudulent conduct do not specify how damages awarded thereunder shall be calculated. It has been held in cases arising under these statutes that the "out-of-pocket" rule of damages shall be applied, *Huddleston v. Maclean*, 640 F.2d 534 (5th Cir., 1981); *Wolf v. Frank*, 477 F.2d 467 (5th Cir., 1973); *Madigan, Inc. v. Goodman*, 498 F.2d 233 (7th Cir., 1974); and *Harris v. American Investment Company*, 523 F.2d 220 (8th Cir.,

1975). This rule suggests that actual pecuniary loss rather than loss of bargain is the proper measure of damage. Thus the "out-of-pocket" rule allows recovery of the difference between the actual value of what the injured party gave and what he received.

As recognized by the United States Court of Appeals for the Fifth Circuit in the *Huddleston* case, supra, rescission permits the securities buyer to place upon his seller the burden of any decline in the value of any security after the date of purchase even though only a portion of that decline may have been proximately caused by the defendant's wrong. Rescission, therefore, is unjust insofar as it compensates for nonspecific risks which the buyer assumes by entering the market. This reasoning is particularly applicable to the facts of this case because the SWENSONS were in control of AMARILLO WRANGLERS, INC. for an extensive period of time during which the corporation went from a solvent and going concern to one that failed because it could not pay its debts. It was only after this failure of the corporation that the SWENSONS sued to rescind their stock purchase.

The rule with regard to the remedies for violation of Section 12 of the 1933 Securities Act is well stated by Bloomenthal, *Securities and Federal Corporate Law*, Section 8.26 and by Loss, *Securities Regulation*, 2nd Edition, Volume III, Page 1721.

It is, therefore, submitted that the SWENSONS are not entitled to the remedy of rescission and that they are relegated solely to the remedy of damages. This concept was expressly recognized in the first appeal of this case to

the United States Court of Appeals for the Fifth Circuit wherein it was held that this case was being remanded to the District Court for a determination of "damages * * *" (626 F.2d at page 428). It would have been a simple matter for that court to have reversed and rendered judgment for the SWENSONS if the remedy of rescission was thought to be appropriate.

It is also submitted that no damages are recoverable by the SWENSONS in this case. It is undisputed in this record that the SWENSONS paid $90,000.00 for 60 shares of stock or an amount of $1,500.00 per share. Each of their sales to third parties resulted in a return to the SWENSONS of at least $1,500.00 per share (allowing appropriate adjustment of the 5 to 1 stock split). The ENGELSTADS had nothing whatever to do with the price for which the SWENSONS resold the stock to third parties. Presumably, these third party sales which for the most part were consummated soon after the SWENSONS' purchase represented the market value of the stock at that time. If the stock was worth what the SWENSONS paid for it, they have suffered no loss and are, therefore, not entitled to a recovery of any nature in this case. *Mott v. Tri-Continental Financial Corporation*, supra. At least if the value of the stock is not conclusively established in this record, the case should be remanded to the District Court to conduct an additional evidentiary hearing concerning the value of the stock at the time it was purchased by the SWENSONS in order to properly apply the appropriate "out-of-pocket" measure of damage.

To allow rescission as the courts below have done without giving credit for the debts of the corporation paid

by the ENGELSTADS from the consideration paid for the stock appears to be wholly unjust. The courts should not allow the SWENSONS to be compensated by the ENGELSTADS for the sum of $26,000.00 admittedly paid for the debts of the corporation when the SWENSONS have already been reimbursed for these debts.[2]

[2] Beginning on Page 127 of Vol. 1 of the Transcript, CAL SWENSON testified:

"Q. Cal, isn't that a note that Amarillo Wranglers, Inc. gave to you and your wife to reimburse you for the $26,000.00?

A. Yeah, I guess that is what it is.

Q. I think it is, and what is the date of the note, please?

A. April, 1976.

Q. Uh huh, and were payments made on that note, please?

A. To us?

Q. Yes.

A. There may have been one or two. I am not certain. Not a very big amount of money was ever paid to us.

Q. But, as a matter of fact, Amarillo Wranglers, Inc. owes you and your wife $26,000.00 plus interest, less the amount that has been paid to you on this note to reimburse you for the $26,000.00 worth of debts you paid, isn't that true?

A. Would you repeat that?

Q. Yes sir. The corporation, Cal, gave you and your wife the note to reimburse you, you and your wife, personally for the debts of the corporation you paid, is that true?

A. That's what that note is, yes.

Q. Yes. And the company still owes you the money less what it had already paid you, correct?

A. Well, I feel somebody owes me the money, you know. I don't know if it is the company.

Q. Well, this instrument says it is Amarillo Wranglers, Inc., doesn't it?

A. Yes sir.

Q. Now, let's talk about how much you have been paid on that note, do you know?

A. I don't have the figures.

Q. Maybe I can help.

A. O.K.

Q. In those same answers to interrogatories that we talked about earlier, you and your wife responded that Amarillo Wranglers, Inc. made three payments. Just a second. One was in the

When the SWENSONS accepted a note from the corporation and received payment thereon, they were reimbursed for the debts paid and they should not now receive a second payment from the ENGELSTADS. The SWENSONS have already been paid the stipulated amount of $11,573.79 and they still hold a promissory note from the corporation for the balance of the debts paid on its behalf.

CONCLUSION AND PRAYER

There now exists a conflict in the decision of the Courts of Appeals of the United States with reference to the interpretation of the remedy afforded to a buyer of unregistered securities in interstate commerce where the buyer has subsequently sold the securities but has attempted to re-acquire them for tender in their action against the seller. Under the particular facts of this case, the SWENSONS are not entitled to a complete return of the consideration paid; rather the "out-of-pocket" rule of damages should be applied and under the undisputed

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footnote 2, continued

amount of $2,800.00; one was in the amount of $2,777.78; and one in the amount of $2,755.55, is that true?

A. I would say that would be true, yes.

Q. All right, and then in August of 1976, the corporation paid to you $2,740.46. That's also true, isn't it?

A. I would have to look back. I —.

Q. Well, that is what you swore to in the answers to the interrogatories, so that would be correct, would it not?

A. Yeah.

* * * THE COURT:

Are those figures correct?

MR. SCHACHTER:

They are, we will stipulate to them.

* * * THE COURT:

We need no further testimony. He has been paid that much by stipulation and the Court so orders."

record, the stock at issue in this case was worth what the SWENSONS paid for it precluding their recovery of any sum from the ENGELSTADS. Alternatively, this case should be remanded to the District Court for additional proceedings to determine the actual value of the stock purchased by the SWENSONS at that time with direction to apply the "out-of-pocket" rule to measure any recovery by the SWENSONS.

Respectfully submitted,

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APPENDIX A

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 81-1003

Cal Swenson and Carolyn Swenson,
Plaintiffs-Appellees,

vs.

Richard Engelstad and Ralph Engelstad,
Defendants-Appellants.

Appeal From the United States District Court
For the Northern District of Texas

(October 16, 1981)

Before AINSWORTH, INGRAHAM and TATE, Circuit Judges

PER CURIAM: AFFIRMED. See Local Rule 21.

APPENDIX B

In The United States District Court
For the Northern District of Texas
Amarillo Division

Civil Action No. CA-2-76-155

Cal Swenson and Carolyn Swenson,
Plaintiffs,

v.

Richard Engelstad and Ralph Engelstad,
Defendants.

JUDGMENT

Pursuant to the Mandate from the United States Court of Appeals for the Fifth Circuit, on remand, and pursuant to the directions contained in the opinion of the United States Court of Appeals for the Fifth Circuit dated September 24, 1980, the following judgment is entered:

It is Ordered, Adjudged and Decreed that the plaintiffs, Cal Swenson and Carolyn Swenson, do have and recover of and from the defendants, Richard Engelstad and Ralph Engelstad, jointly and severally, the sum of $96,666.67 together with pre-judgment interest thereon at the rate of six percent (6%) per annum from March 3, 1976 to February 9, 1979, and at the rate of nine percent (9%) per annum on said principal and interest from February 9, 1979 until paid.

It is further Ordered, Adjudged and Decreed that the additional sum of $19,333.33 shall be recovered by the plaintiffs, Cal Swenson and wife, Carolyn Swenson,

against the defendant, Richard Engelstad, but not against Ralph Engelstad, together with pre-judgment interest thereon at the rate of six percent (6%) per annum from March 3, 1976 to February 9, 1979, and at the rate of nine percent (9%) per annum on said principal and interest from February 9, 1979 until paid.

All costs are taxed against the defendants.

The Clerk will furnish a copy hereof to each attorney.

this 12th day of December, 1980.

/s/ Halbert O. Woodward

HALBERT O. WOODWARD
Chief Justice
Northern District of Texas

APPENDIX C

In The United States District Court
For the Northern District of Texas
Amarillo Division

Civil Action No. CA-2-76-155

Cal Swenson and Carolyn Swenson,
Plaintiffs,

v.

Richard Engelstad and Ralph Engelstad,
Defendants.

FINAL JUDGMENT

This action came on for trial before the Court and a jury. Honorable Halbert O. Woodward, United States District Judge, presiding, and the issues having been duly tried and the jury having duly rendered its verdict.

It is ORDERED, ADJUDGED AND DECREED, that the Plaintiffs, CAL SWENSON and CAROLYN SWENSON, take nothing from the Defendants, RICHARD ENGELSTAD and RALPH ENGELSTAD, and that the action be dismissed on the merits. It is furthered Ordered that the Defendants, RICHARD ENGELSTAD and RALPH ENGELSTAD, recover of the Plaintiffs, CAL SWENSON and CAROLYN SWENSON, their costs of this action.

DATED AND ENTERED this 9th day of Februarv, 1979.

The Clerk will furnish a copy hereof to each attorney.

/s/ Halbert O. Woodward
HALBERT O. WOODWARD
Chief Judge
Northern District of Texas

APPENDIX D

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 79-1662

Cal Swenson and Carolyn Swenson,
Plaintiffs-Appellants,

vs.

Richard Engelstad and Ralph Engelstad,
Defendants-Appellees.

(September 24, 1980)

Before HILL, RUBIN and ANDERSON, Circuit Judges.
JAMES C. HILL, Circuit Judge:

Plaintiffs CAL and CAROLYN SWENSON commenced this action against Defendants RALPH ENGELSTAD and RICHARD ENGELSTAD,[1] seeking to recover damages sustained as a result of their purchase of unregistered securities. Recovery was sought under §12(1), §12(2), and §15 of the Securities Act of 1933, 15 U.S.C.A. §771 (1), §77o; §10(b) of the Securities Exchange Act of 1934, 15 U.S.C.A. §78j(b), SEC Rule 10b-5, 17 C.F.R. §240.10b-5; and §17.50 of the Texas Deceptive Trade Practices — Consumer Protection Act, Tex. Bus. & Com. Code Ann. tit. 2, §17.50 (Vernon Supp. 1980). Prior to trial, Plaintiff's state law claims were dismissed. The remainder of the claims were submitted to a jury on special interrogatories. Based on the jury's answers, the

[1] From time to time we will refer to Ralph Engelstad and Richard Engelstad merely as Ralph and Richard.

District Court entered Judgment for the Defendants on all the federal claims.

I. FACTS

In 1975, Ralph founded the Southwest Hockey League (SHL). At all pertinent time, he was the President of the SHL and its sole stockholder. Shortly after the league was formed, Richard purchased the right to start an SHL franchise in Amarillo, Texas.[2] The now defunct Amarillo Wranglers hockey team was owned by Amarillo Wranglers, Inc. The corporation initially issued 75 shares of stock. Fifty shares were purchased by Richard, and 5 shares each were purchased by Tuggie Tuckness, Bill O'Grady, Billy Parker, Tim Guss and Ray Paetzold.[3] Before the beginning of the first season, Cal Swenson was hired to coach the Wranglers. In early 1976, the Swensons became interested in purchasing ownership interest in Amarillo Wranglers, Inc. After several negotiating sessions between the Swensons, Richard and Ralph, the Swensons agreed to purchase Richard's 50 shares, Tuckness' 5 shares, O'Grady's 5 shares, and Parker's 5 shares.[4] The purchase price for the 65 shares was $116,000.00. It is undisputed that the stock of Amarillo Wranglers, Inc. has never been registered with the Securities Exchange Commission.

II. §10(b), Rule 10b-5

[1, 2] Plaintiffs alleged that Richard and Ralph made

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[2] When the Southwest Hockey League was formed, Richard was Vice-President. He later served as Commissioner of the league.

[3] Tuckness did the public relations work for the Amarillo Wranglers. O'Grady was the team's first manager.

[4] Tuckness, O'Grady and Parker were not named defendants in this suit.

various misrepresentations in connection with the sale. The jury found that the Swensons "intentionally refused to investigate the facts bearing upon their investment in the stock of Amarillo Wranglers, Inc." This amounts to a finding that the Plaintiffs failed to exercise "due diligence" in purchasing the stock. Due diligence is an element of a cause of action under §10(b) and Rule 10b-5. *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), cert. denied, 434 U.S. 911, 98 S.Ct. 312, 54 L.Ed.2d 197 (1977). The jury's finding, which is supported by the record, bars any recovery under §10(b) and Rule 10b-5.

III. §12(1), §15

A. *The Prima Facie Case*

[3, 4] The Securities Act of 1933 imposes strict liability on offerors and sellers of unregistered securities.[5] *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 686 (5th Cir. 1971). Recovery may be had under §12(1)[6] "regardless of whether [the purchaser] can show any degree of fault, negligent or intentional, on the seller's part." Id. There are three elements to a prima facie case: (1) the sale or offer to sell securities; (2) the absence of a registration statement covering the securities; and (3) the use of the mails or facilities of interstate commerce in connection with the sale or offer. *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 899 (5th Cir. 1977); *Lewis v. Walston & Co., Inc.*, 487 F.2d 617, 621 (5th Cir. 1973).

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[5] See generally I. L. Loss, *Securities Regulation 1683-99* (2d ed. 1961).

[6] The prohibition on selling unregistered securities actually is found in §5(a) of the 1933 Act, 15 U.S.C.A. §77e, Section 12(1) gives effect to §5(a) by authorizing recovery in a civil action against "[a]ny person who — (1) offers or sells a security in violation of Section 77e of this title . . . 15 U.S.C.A. 771 (1).

[5-7] Section 15 of the 1933 Act imposes liability on any person who "controls" a seller or offeror of unregistered securities.[7] See 15 U.S.C.A. 77o. The plaintiff's burden under §15 is to establish control. *Hill York,* 448 F.2d at page 694. The defendant can rebut a prima facie case of controlling personal liability with evidence that "he had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[8] 15 U.S.C.A. §77o; see *Hill York*, 448 F.2d at page 695 n.22; *Safeway Portland Employees' Federal Credit Union v. Wagner & Co., Inc.*, 501 F.2d 1120, 1124 (9th Cir. 1974).

B. *The Private Offering Exemption*

[8, 9] Section 4(2) of the 1933 Act, 15 U.S.C.A. §77d(2), exempts from the registration requirements "transactions by an issuer not involving any public offer."[9] The so-called private offering exemption is an affirmative defense which must be raised and proved by

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[7] Section 15 of the 1933 Act provides in pertinent part:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under Sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . 15 U.S.C.A. §77o.

[8] The defendants seem to assume that the plaintiffs were required to prove that the controlling person knew or should have known of the facts forming the basis of the controlled person's liability. This is incorrect. In *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 695 n.22 (5th Cir. 1971), we stated that lack of knowledge is a special defense to controlling person liability which the defendant bears the burden of proving.

[9] For a comprehensive list of writings on the private offering exemption, see *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 608 n.11 (5th Cir. 1975), vacated and remanded, 426 U.S. 944, 96 S.Ct. 3161, 49 L.Ed.2d 1181 (1975).

the defendant. See, e.g., *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126, 73 S.Ct. 981, 985, 97 L.Ed. 1494 (1953); *Doran*, 545 F.2d at 893; *Woolf v. S. D. Cohn & Co.*, 515 F.2d 591, 608-09 (5th Cir. 1975), vacated and remanded on other grounds 426 U.S. 944, 96 S.Ct. 3161, 49 L. Ed.2d 1181 (1976). Whether an offering is public or private is a question of fact which must be resolved in light of the particular circumstances of each case. See *Hill York*, 448 F.2d at page 687.

There are four factors that we have found to be useful reference points in evaluating the character of a given offering:

1. The number of offerees and their relationship to each other and to the issuer.[10]
2. The number of units offered.
3. The size of the offering.
4. The manner of the offering.[11]

SEC v. Continental Tobacco Co. of S.C., 463 F.2d 137, 158 (5th Cir. 1972).

[10] Although this test appears to emphasize quantitative factors, the ultimate issue in determining the availability of the private offering exemption is "whether the particular class of persons affected need the protection of the Act." Id. For this reason, we have held that the defendant must establish that each and every offeree either had the same information that would

[10] A small number of offerees indicates that the offering was private, while a large number indicates that it was public. But the number of offerees is dispositive. "No particular numbers are prescribed. Anything from two to infinity may serve; perhaps even one..." *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 n.11, 73 S.Ct. 981, 985 n.11, 97 L. Ed. 1494 (1953).

[11] For example, "public advertising is incompatible with the claim of private offering." *Hill York*, 448 F.2d at 689.

have been available in a registration statement or had access to such information.[12] See *SEC v. Spence & Green*, 612 F.2d 896, 902 (5th Cir. 1980; *Doran*, 545 F.2d at 903-04, 905-06.

D. *Richard Engelstad's Liability*

Plaintiffs' case against Richard was based on his having sold them 50 shares of unregistered Amarillo Wranglers, Inc. stock and on his having been a controlling person with respect to the 5 shares purchased from O'Grady and the 5 shares purchased from Tuckness.

It is conceded that the second and third elements of a § 12(1) prima facie case are present in this case. The only issue, therefore, is whether Richard was a seller within the meaning of the statute.

Richard clearly was a seller in the ordinary sense of the word; he parted with title to 50 shares of stock in return for a sum of money. Nevertheless, he argues that this Circuit has held that one is not a seller unless his actions were a proximate cause of the sale. This argument was made at trial and accepted by the trial judge. The jury was asked, in Special Interrogatory No. 1, to decide whether the actions of Richard were a proximate cause of the sale:

Do you find a preponderance of the evidence that the actions of the Engelstads were a proximate cause of the Swensons' purchase of the stock in question?

[12] Evidence of the offerees' investment sophistication also is helpful. See *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 902 N.10 (5th Cir. 1977). Lack of proof of investment sophistication, however, does not preclude a finding that the offer was private. Id. By the same token, proof of investment sophistication is of little value unless accompanied by evidence that the offerees had or had access to the information that would have been included in a registration statement. Id. at 902.

Answer for each of the Engelstads:

"His actions were a proximate cause"

or

"His actions were not a proximate cause"

Answer: RALPH ENGELSTAD:
RICHARD ENGELSTAD:

"PROXIMATE CAUSE" means that cause which, in a natural and continuous sequence, unbroken by any new and independent cause, produces an event, and without which cause such event would not have occurred; and in order to be a proximate cause, the act or omission complained of must be such that a person using ordinary care would have foreseen that event, or some similar event, might reasonably result therefrom. There may be more than one proximate cause of an event.

In *Hill York Corp. v. American International Franchises, Inc.*, we were presented with the argument that §12(1) does not reach persons other than those who actually part with title to securities. Declining to read §12(1) as requiring privity between plaintiff and defendant, we held that the appropriate inquiry is whether " 'the injury to the plaintiff flow[ed] directly or proximately from the actions of this particular defendant.' " 448 F.2d at 693 (citing *Lennerth v. Mendenhall*, 234 F.Supp. 59, 65 (N.D. Ohio 1964). Nowhere in *Hill York* did we so much as intimate that our adoption of a proximate cause test was meant to narrow the class of persons subject to liability under §12(1). Rather, it is clear that our intent was to give a liberal construction to the word seller to comport with the remedial purposes of the 1933 Act. Our later opinion in

Lewis v. Walston & Co. confirms that *Hill York* did not change the law with respect to those who actually part with title to securities. In *Lewis*, after noting that the defendant "was not a 'seller' in the most common sense of the word," 487 F.2d at 621, we stated"

> That, however, is not conclusive under 12(1), for the courts have recognized that *other parties* who participate in the negotiations of or arrangements for the sale of unregistered securities 'sell' those securities within the meaning of §12(1) . . . In Hill York, this Court announced the test applied in this Circuit to determine whether a participant in the arrangement for a sale 'sells' securities within the meaning of §12(1).

Id. at 621-22 (emphasis added).

[11,12] Today we make it clear that one who parts with title to securities in exchange for consideration is a seller for purposes of §12(1). To such a person, the proximate cause test is inapplicable. Therefore, with respect to Richard, we conclude that the trial court erred in submitting Special Interrogatory No. 1 to the jury. With that issue resolved, it is clear that the Swensons established a prima facie case as to the 50 shares purchased from Richard.

As to those shares, Richard attempted to establish a private offering defense. The plaintiffs objected to submission of that issue to the jury, arguing that there was no evidence upon which the jury could find that the offering was private. The objection was overruled. The jury found that the offering was private. Plaintiffs' post-trial motion for judgment n.o.v. was denied. Having carefully considered the record, we conclude that the plaintiffs' motions should have been granted.

[13-17] The record is devoid of any indication that the defense carried its burden of proving the number or identity of the offerees. There was evidence that Richard knew that the Swensons planned to raise money to purchase the stock by selling options to others. Any people who Richard knew would be purchasing from the Swensons would be offerees. See *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2nd Cir. 1969). But the defense made no attempt to prove the number of people who were to buy from the Swensons or to identify them. The defendants' "failure to adduce any evidence regarding the number of offerees [is] fatal" to a private offering defense. *Doran*, 545 F.2d at 901, see *Continental Tobacco*, 463 F.2d at 161; *Henderson v. Hayden Stone, Inc.*, 461 F.2d 1069, 1071-72 (5th Cir. 1972). We take note of another major flaw in the defense. The only evidence tending to show that the Swensons had the information that a registration statement would have contained, or access to the same, is that Cal Swenson, in his capacity as coach of the Wranglers, had access to the corporation's books and was shown these books during one of the negotiating sessions with Richard. The evidence does not establish, however, that these books contained all the information that Schedule A of the 1933 Act, 15 U.S.C.A. §77aa, would have required a registration statement to contain. Even if they did, the exemption still would be unavailable because there was no proof that the people who had agreed to buy the Swensons' stock were given this information or had access to it.[13]

[13] There is another aspect of the defense presentation that causes us some concern. The private offering exemption is available only to "issuers." See 15 U.S.C.A. §77d(2). Issuer is defined in §2(4) of the Act as "every person who issues or proposes to issue any security . . . 15 U.S.C.A. §77b(4). The term "issuer" is not synonymous with the

[18] Analyzing the evidence, as we must, in the light most favorable to the defendant, *Boeing v. Shipman*, 411 F.2d 365, 374 (5th Cir. 1969) (en banc), we find that the court erred in submitting the private offering to the jury. As to the 50 shares purchased from Richard, the plaintiffs are entitled to a judgment as a matter of law.[14]

[19, 20] The jury found that Richard controlled Tuckness and O'Grady. In Special Interrogatory No. 9, the jury was asked whether Richard knew of omissions or misrepresentations in connection with the entire transaction. The jury answered that question in the negative. Relying on that answer, Richard argues that he established the defense of lack of "knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled persons is alleged to exist." 15 U.S.C.A. §77o. The defendant misreads the statute. Knowledge of omissions or misrepresentations is not an element of §12(1) liability. The only facts that Richard had to know to be held liable as a controlling person were the three elements of a §12(1)

term "seller." If Richard merely was a seller, rather than an issuer, see *Darwin v. Jess Hickey Oil Corp.*, 153 F.Supp. 667, 672 (N.D. Tex. 1957) (private offering exemption not applicable to "secondary or private transactions"), it was error to submit the private offering to the jury. If so, Richard might have been entitled to the exemption contained in §4(1) of the 1933 Act for "transactions by any person other than an issuer, underwriter, or dealer." 15 U.S.C.A. §77d(1). We do not decide these issues, however, because they were not raised at the trial.

[14] As an alternative defense, the defendants claimed that the Swensons waived the protection of §12(1) by going ahead with the transaction despite knowledge of misrepresentations and omissions made by the Engelstads. The waiver question was submitted to the jury. While waiver may have been relevant to the plaintiffs' §10(b) and 10b-5 claims, it was not relevant to their §12(1) claims. In *Meyers v. C & M Petroleum Producers, Inc.*, 476 F.2d 427, 429 (5th Cir.), cert. denied, 414 U.S. 829, 94 S.Ct. 56, 38 L.Ed.2d 64 (1973), we held that waiver is not an available defense in §12(1) cases.

prima facie case outlined above. He does not deny knowledge of any of the facts. Therefore, the Swensons also are entitled to a judgment against Richard as to the 5 shares purchased from Tuckness and the 5 shares purchased from O'Grady.

D. *Ralph Engelstads' Liability*

[21] The §12(1) and the §15 claims against Ralph require little discussion. The jury found that his actions were not a proximate cause of the sale. Because he was not a seller in the ordinary sense of the word, it was proper to submit the proximate cause issue to the jury. Nevertheless, the Swensons are entitled to a judgment against him as to the 50 shares sold by Richard. The jury found that Ralph controlled Richard. Ralph failed to carry the burden of proving lack of knowledge of the facts necessary to the controlled person's liability.

IV. State Law Claims

The District Court dismissed the Swensons' claims under the Texas Deceptive Trade Practices — Consumer Protection Act, Tex. Bus. & Com. Code Ann. title 2, §17.50 (Vernon Supp. 1980), finding that the statute does not protect purchasers of securities. We agree.

Section 17.50 grants a cause of action to any "consumer" who has been the victim of a deceptive trade practice. Section 17.45(4) defines "consumer" as follows: "an individual, partnership, corporation or governmental entity who seeks or acquires by purchase or lease, any goods or services," Tex. Bus. & Com. Code Ann. tit. 2, §17.45(4) (Vernon Supp. 1980) (emphasis added). "Goods" are defined as "tangible chattels or real property purchased or leased for use." Id. §17.45(1). The Swensons

argue that stock certificates are "tangible chattels" as that term is used in §17.45(1) and, therefore, that they are consumers entitled to maintain an action under §17.50.

[22] Apparently, no Texas court has as yet had the occasion to address this issue. The most persuasive authority we have been able to find is *Cowen v. First National Bank of Brownsville*, 94 Tex.546, 63 S.W. 532 (1901). In *Cowen*, the issue was whether certificates of deposits were goods or chattels. Categorizing the certificates as "evidence of incorporeal rights,' " 63 S.W. at 533 (quoting Schouler, *Personal Property* §11), the court held that they were not goods or chattels. 63 S.W. at 533. In so holding, the court noted, as other examples of incorporeal rights, " '[b]ills and notes, certificates of stock, [and] *registered securities*.' " Id. (quoting Schouler, *Personal Property* §11) (emphasis added). Based on Cowen, we think it reasonable to assume that the Texas Supreme Court would find that stock certificates are not covered by the Texas Deceptive Trade Practices — Consumer Protection Act. We therefore affirm the dismissal of the Swensons' state law claim against the Engelstads.

CONCLUSION

We affirm the district court's order dismissing plaintiff's state law claims. We also affirm the entry of judgment in favor of the defendants on the §10(b) and Rule 10b-5 claims. As to Richard, we reverse the entry of judgment in his favor on the §12(1) and §15 claims, and remand for a determination of damages and entry of a judgment for the plaintiffs. As to Ralph, we reverse the part of the judgment absolving him from liability under

§15 for Richard's sale of 50 shares of stock, and remand for a determination of damages and entry of a judgment for the plaintiffs.[15]

AFFIRMED in part; REVERSED in part; REMANDED in part.

[15] In view of our holding, we need not reach the issues raised in connection with plaintiffs' §12(2) claims.

Opposition

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No. 81-991

In The

Supreme Court of the United States

OCTOBER TERM, 1981

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Petitioners,

vs.

CAL SWENSON and CAROLYN SWENSON,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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ARGUMENT

The per curiam affirmance without opinion by the Fifth Circuit does not create a conflict with decisions of the Second Circuit. To the contrary, the decision in this case accords with Judge Friendly's opinion in *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2d Cir. 1969).

As did the Swensons, Katz sued under Section 12(1) of the Securities Act of 1933 (15 U.S.C. § 77l) for recovery of consideration paid for unregistered securities — some of which he had resold to approximately twenty persons. Judge Friendly held that Katz could recover for all the securities. The key in *Katz,* as in this case, was that the plaintiff complied with Section 12(1) by tendering to the defendants all the securities he purchased from them.

The case that the Engelstads say creates an "apparent conflict" is *Mott v. Tri-Continental Financial Corp.*, 330 F.2d 468 (2d Cir. 1964). But most of the *Mott* opinion, including the portion quoted by the Engelstads, deals with claims under the common law of fraudulent misrepresentation. The short discussion of Section 12(2) of the Securities Act of 1933 relies on the fact that Mott did not own any of the securities and, therefore, could not tender any of them to the defendant as required by the plain wording of Section 12. Because he could not tender, Mott could not "recover the consideration paid."[1] At no time did the Swensons resell all the shares they purchased from the Engelstads; and combining shares they never resold with shares they reacquired by rescinding resales before bringing their claims under Section 12(1), the Swensons made a complete tender to

1 The Engelstads repeatedly refer to the remedy under Section 12 as "rescission." This is common in the cases as a short-hand reference, but the remedy is purely statutory. The word "rescission" does not appear in the statute, and the remedy of recovery of the consideration paid is not restricted by technical limitations of the theory of rescission. As stated in Cady v. Murphy, 113 F. 2d 988 (1st Cir. 1940), "[T]he section does not use the word "rescission" nor indicate that the remedy provided is limited to rescission in the narrower sense as between principals to the transaction." *Id.* at 991. This is another reason why the discussion of restitution in *Mott* is inapposite.

the Engelstads, something Mott never tried to do.

A second inadequacy in the Engelstads' reliance on *Mott* is that *Katz v. Amos Treat Co.*, 411 F.2d 1046 (2d Cir. 1969), was decided by the same court five years after *Mott*. Judge Lombard, who wrote the opinion in *Mott*, was on the *Katz* panel, which unanimously decided that recovery of the consideration paid could be granted to Katz, who — like the Swensons — was tendering all the stock he purchased, notwithstanding the fact that "half of Katz's initial $50,000.00 investment . . . and part or all of Katz's second $100,000.00" came from third parties. 411 F.2d at 1054.

Not only is the present case consistent with Second Circuit cases, but it also follows the commentators. Professor Loss discusses remedies under Section 12 in 1 L. Loss, Securities Regulations 1721 (2d ed. 1961). Loss refers to his earlier discussion of damages under various states' securities laws, in which he concludes that a tender of repurchased securities should be sufficient to obtain return of the purchase price originally paid:

> Suppose the buyer resells the securities before he discovers that they were sold to him in violation of the statute, and he then repurchases the same amount of equivalent securities on the market for purposes of tendering them to the seller in a rescission action. The courts seem understandably reluctant to require restoration of the identical pieces of paper in the securities field. Although the general requirement may have historical significance in the conflict between law and equity, it makes no sense when applied to fungibles like shares of stock or bonds of the same class. It would seem fairly safe, therefore, to tender equivalent securities purchased on the market when the original securities were resold by the buyer before dis-

covery of the seller's violation.

Id. at 1674-75 (footnotes omitted). If a person can reacquire securities on the open market, surely he can rescind his sales of unregistered securities and thereby return the purchase price to those who purchased from him.

The American Law Institute's proposed Federal Securities Code also allows for the tender of repurchased securities. Its remedy for the sale of unregistered securities is defined as follows:

> (d) RESCISSION.—For purposes of Section 1702, "rescission" means —
>
> (1) if the plaintiff is a buyer, recovery *(on tender of a security of the same class* before entry of judgment) of the amount that he paid (with interest) less any return (with interest) that he received on the security... .

ALI, Federal Securities Code § 1702(d) (emphasis added). The American Law Institute declares that its proposed remedy reflects the present status of the law applicable to Section 12(1) violations. In its introductory comments to Section 1708, the American Law Institute explains that its remedy for fraud differs from its remedy for registration violations[2] and that for registration violations there "should be no undue break with the rescission formula of Section 12 . . . now on the books for almost fifty years." Under the proposed

2 The failure-to-register remedy is harsher and less subject to variance than the fraud remedy. It effectuates the policy of deterring the sale of unregistered securities. For this reason, among others, the cases cited by the Engelstads under Rule 10b-5, such as Wolf v. Frank, 477 F.2d 467 (5th Cir. 1973); Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969); and Sarlie v. R. L. Bruce Co., 265 F. Supp. 371 (S.D.N.Y. 1967), are not pertinent.

statute, as under present law, the crucial fact is tender. No reduction in recovery is made when a full tender occurs, as it did in this case.

The cases cited by the Engelstads in support of the "out-of-pocket" remedy are fraud cases brought under the judicially created cause of action implied from Rule 10b-5, where courts have lacked a statutory measure of damages. But no such problem exists for Section 12(1), which expressly provides as a civil remedy that, upon tender, the purchaser recovers "the consideration paid."

In addition to being wrong, the Engelstads' arguments are tardy. At the trial and in the first appeal the Engelstads never attacked the tender or the legality of the rescission agreements between the Swensons and their purchasers. No jury issue was requested or submitted on whether and to what extent the Swensons received income from resales.

The second question the Engelstads seek to have reviewed is the factual inquiry into how much, if any, if the purchase price had been reimbursed to the Swensons by Amarillo Wranglers, Inc. The jury, the district court, and the court of appeals decided this issue against the Engelstads. No special and important reason exists for review of this fact issue.

In addition, the Engelstads' argument on this score in its present form was raised for the first time only after the judgment was signed in the trial court upon remand following the first appeal. The court of appeals properly affirmed the trial court judgment.

CONCLUSION

Because this case does not involve special and important questions requiring this Court's review, Cal and Carolyn Swenson respectfully pray that the petition for writ of certiorari be denied.

Respectfully submitted

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